"INTERSTATE HIGH COST AFFORDABILITY PLAN"

A Proposal by U S WEST
March 6, 1998

Questions and Answers

Q. What is the Interstate High Cost Affordability Plan?

A. The Interstate High Cost Affordability Plan (IHCAP) is a way to assure the availability of affordable basic telephone service and network access to all Americans, particularly those living in rural and other high cost areas.

Q. Why is a plan such as the Interstate High Cost Affordability Plan necessary?

A. The Telecommunications Act of 1996 states that customers in all regions of the Nation, including "rural, insular and high cost areas" should have access to telecommunications services and advanced services "…at rates that are reasonably comparable to rates for similar services in urban areas". (Section 254(b)(3)) The Act directed the FCC, by May 8, 1997, to develop a plan to carry out these provisions.

Q. Didn't the plan announced by the FCC in their May, 1997 decision accomplish this directive?

A. A growing number of state regulators, state legislators, and spokespeople for rural America believe that the May 1997 Order fell short of the directives contained in the 1996 Act to assure affordable access for all Americans. Attachment I contains a summary of comments from various parties. U S WEST is proposing the IHCAP to the FCC in a constructive effort to find a middle-ground solution to accomplish the objectives of the 1996 Act.

Q. What did the FCC propose last May, and why did it fail to meet the directives of the Act?

A. The FCC defined a "benchmark" level (roughly $30 for residential customers) above which explicit universal service support would be required to assure affordable service. They also directed that a "proxy cost model" be developed to determine the cost of serving customers by "small areas of geography", such as Census Block Groups, Wire Centers or Grids. Costs for customers above the benchmark level would be aggregated and recovered from an explicit universal service mechanism. Recovery of these costs would be split into two pieces, with 25% of these costs recovered from an Interstate fund, and the remaining 75% of the costs recovered from separate State funds developed and administered by each state. The problem is that, for some states, removing all of the present implicit support and making it explicit would result in surcharges which could, themselves, threaten the basic concept of affordability.

Q. Can you provide an example of how the impact would vary between the states?

A. Attachment II is a white paper released by U S WEST in September of 1997 titled *Funding Universal Service, National Fund vs. Separate Funds* which attempts to analyze this problem. It compares the impact of the "75/25" funding plan proposed in the FCC's order, with a national fund where all interstate and intrastate revenues would be assessed an equivalent surcharge. Of course, until the FCC finalizes the proxy cost model, the exact size of the fund will not be known. Also, under the FCC's timetable, only "non-rural" LECs (as defined by the 1996 Act) will go under the new plan beginning in 1999. Rural LECs are presently scheduled to go under a similar plan in 2001. The numbers presented in this paper assume a fund size roughly halfway between the extremes which have been estimated for the total industry-wide cost of universal service. While the exact amount of the necessary surcharges are still unknown, the relative impact among the states will likely hold constant. As is obvious from the paper, many rural states experience a seriously disproportional impact vis-a-vis the more urban states.

Q. How does the IHCAP plan work?

The IHCAP defines a second "super-benchmark" to identify the "very-high" cost customers. Costs between the basic-benchmark ($30/month) and the super-benchmark (say, $50/month) would be handled the same as in the FCC's proposed plan, with 25% of the funding responsibility assigned to the interstate jurisdiction, and the remaining 75% assigned to the states. Costs above the super-benchmark would be assigned 100% to the interstate jurisdiction. Attachment III is a white paper released by U S WEST in November of 1997 titled, *What if a Federal Fund Covered All Costs Over $50?* This paper was developed as a result of discussions during and around the NARUC Convention in Boston, and has been reviewed in concept with many Federal and State regulators and other interested parties. The numbers used in the paper, similar to those in Attachment II, reflect a "mid-range" universal service cost estimate, and represent costs for the entire LEC industry, not just the "non-rural" LECs. Based upon our analysis to date, removing these "super-high" costs from the intrastate equation would appear to level the playing field, and leave each state with a more solvable problem.

Q. Will the Interstate High Cost Affordability Plan eliminate the need for State Commissions to address the Universal Service issues?

A. Not at all. The proposal we are making would leave the primary role for rebalancing rates, defining the need for explicit support, and assuring the continued availability of affordable service with the people who know the local customers and the local markets best - the State regulators. The size of the interstate fund is kept smaller by assuming full support responsibility only for those costs in excess of $50/month (states would still be responsible for 75% of the costs between $30 and $50). Said another way, the interstate fund would cover 25% of costs between $30 and $50, and 100% of customer costs in excess of $50. Most of the customers who would be eligible for funding under the single-benchmark proposal, and a significant portion of the funding need, is due to customers slightly above the $30 benchmark but shy of the $50 super-benchmark. By leaving responsibility for most of these costs with state regulators, they will be able to devise rate rebalancing and/or explicit funding plans which are right for their markets. This plan also reduces the burden on customers in lower cost states, since it only requires them to contribute support to those customers who unquestionably will require some sort of assistance to retain affordable service.

Q. Why is Federal help needed here? Why can't the states handle this themselves?

A. Some states can handle universal service themselves. All states have some customers who are located far from the central office and are costly to serve. What makes the impact of removing all present implicit funding more severe in some states than others is the relative number of low cost customers within the state. While states like California and New York have many high cost customers to support, they also have large concentrations of low cost customers in major urban areas to spread this support over. As a result, the per-customer impact of supporting high cost customers is relatively small. Other states, such as Montana, Wyoming and the Dakotas, have many very-high cost customers, but lack the large urban centers to spread these costs over. As a result, the per-customer cost of supporting universal service could become so high that affordable service for all customers in the state would become an issue. The purpose of the IHCAP plan is to remove the very high end of the cost average, so that all states are capable of solving the remaining universal service problem themselves.

Q. Is the need for a plan like the Interstate High Cost Affordability Plan limited to the Western states served by U S WEST?

A. Absolutely not. Southern states, such as Mississippi, Kentucky and Alabama, New England states such as Vermont, New Hampshire and Maine, and Appalachian states like West Virginia have similar problems with many high cost customers and relatively few low cost customers. The IHCAP plan has been designed to benefit all Americans.

Q. Why should lower cost states have to pay into the IHCAP plan?

A. Two reasons. First, all states have some customers who are costly to serve. The IHCAP fund will support very high cost customers in all states, reducing the size of the problem that each state must deal with. Second, customers in all areas of the country benefit from ubiquitous access to all people and businesses nationwide.

High cost and rural areas possess agricultural, energy and recreational resources on which urban areas depend. Rural areas contain many customers for goods and services produced in urban areas.

Q. In his remarks to the NASUCA meeting on February 9, 1998, Chairman Kennard outlined eight "principles" to guide the division of funding responsibilities between the Federal and State jurisdictions. Is the IHCAP plan consistent with these principles?

A. While we are not fully aware of what Chairman Kennard had in mind, we believe that a plan like IHCAP can be compatible with the spirit which we read in the Chairman's remarks. It is important that the plan which is developed be simple, equitable and capable of implementation in a relatively short period of time. We look forward to working with the Chairman, the other Commissioners and the FCC Staff in developing a plan which implements the Congressional mandates in a manner which is best for all customers nationwide.

Q. The FCC's May order provides for the implementation of a new explicit funding framework for non-rural LECs on January 1, 1999, but retains the current explicit funding mechanisms for rural LECs until at least 2001. Is the IHCAP plan consistent with this schedule?

A. U S WEST recommends that the IHCAP plan be implemented for non-rural LECs only, beginning in January of 1999. After several years of experience under IHCAP, the Commission will be in a better position to decide what explicit funding plan will best meet the needs of rural LECs and their customers. One thing that we are sure of going forward, however, is that the focus of the Commission's universal service funding programs and principles should be focused on the needs of the rural customer, and not on the size of the company which serves them. In years gone by, it may have made sense to set up explicit funding for smaller LECs (which generally serve high cost territory) and allow the larger LECs to cross-subsidize their higher cost rural customers with lower cost urban customers. The ability of new local competitors to selectively enter local markets effectively eliminates this opportunity for cross-subsidy.

Q. What would be the size of the interstate fund necessary to implement the IHCAP plan?

A. Until the FCC completes the cost proxy model proceeding and decides on the model platform and inputs, the absolute size of the fund can only be estimated. Estimates for the total high cost funding needs of the non-rural LECs range from a low of $3 billion to a high of about $9B. This number is highly sensitive to the cost inputs to the proxy model. During the platform proceeding, the FCC staff has developed a set of "common inputs" which, when run through both the BCPM3 and HAI 5.0a models produce a similar total funding need of around $4.5B for non-rural LECs. Using this $4.5B number, and recognizing that the final number could be slightly higher or slightly lower (U S WEST believes it will be slightly higher) the baseline 25% Interstate funding portion would be approximately $1.1B, requiring a surcharge of approximately 1.6% on interstate retail revenues. When the fund is increased to cover 100% of the costs above $50, the interstate fund for non-rural LECs would become $2.8B, or a 4.2% surcharge. Again, we must stress that these estimates are preliminary, and subject to change based upon the outcome of the proxy model proceeding.

Q. Does this mean that customer's interstate bills would increase by 4.2% or whatever the final answer is?

A. No. An explicit high cost fund is meant to be a replacement for implicit support hidden within present LEC rate structures. Offsetting reductions would be made elsewhere in the rate structure, so the net impact to consumers would be zero. The impact to the high cost rural customer, however, would be significant, since they would be assured of the continued availability and affordability of basic telephone service and network access.

Q. How does the IHCAP compare to the plan which has been circulated by the NARUC Ad Hoc Working Group?

A. We have read the Ad Hoc plan, and have had limited dialogue with the plan's authors. We understand from a workshop at the recently concluded NARUC Winter Meetings that the plan is still considered a "work in progress". Based upon the version of the plan dated January 20, 1998 we would offer the following observations:

- The plan bases funding amounts on statewide averages of cost. To us, averaging implies implicit support, and the objective of this exercise should be to create less implicit support, not more.
- We believe that to achieve the minimum effective fund size, and to use available support most effectively, support must be carefully targeted to the areas which need it most to preserve affordable rural service. This would call for cost analysis at the "small areas of geography" as envisioned in the FCC's May, 1997 order, and not statewide averages of cost.
- We are particularly troubled by the provisions of the plan that call for the development of statewide cost averages, utilizing the costs of all telephone companies. Since averaging creates implicit support, this type of averaging would create implicit support between potential competitors which could threaten the "competitive neutrality" provisions in both the FCC's and Joint Board's guidelines.
- From discussions at the Workshop, it would appear that one objective in the plan is to keep the size of the new fund "roughly the same size" as the present USF. There are also discussions in the latest draft (and at the workshop) about "holding harmless" present levels of support. Given this, we question whether

the funding would pass the "sufficiency" test under the Act. Furthermore, present interstate access charges contain billions of dollars of implicit support. To the extent that the new explicit mechanism is constrained to the size of the old explicit mechanism, the ability of the FCC to move access charges toward cost may be seriously constrained.

- The plan is based, in part, on embedded cost, not the forward-looking cost envisioned by the FCC and the Joint Board.

Q. How does this IHCAP plan relate to the Section 706 Petition which U S WEST recently filed for high speed data services?

A. The U S WEST Section 706 Petition requests that the FCC forbear from three rules which make U S WEST's provision of high speed data services to end user customers uneconomical and, in rural areas, economically unfeasible. While high speed data services are not within the definition of universal services covered by the Act, the U S WEST petition will, upon grant, expand the array of advanced telecommunications services available to all Americans, without direct governmental intervention. Thus, the U S WEST petition is related to the IHCAP plan in that both seek to expand the telecommunications horizons of all Americans.